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# Tax Tips for Forest Landowners for the 2002 Tax Year

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Here is some information to keep in mind when you prepare your Federal income tax return for the 2002 tax year. This discussion is necessarily brief, and you should consult other sources for a more comprehensive treatment of the issues. This information is current as of December 1, 2002 and supersedes Management Bulletin R8-MB 90.

**Basis and Tax Records**

Part of the price you receive from a timber sale is taxable income, but part is also your investment (i.e., basis) in the timber sold. Allocate your total costs of acquiring purchased forestland—or the value of inherited forestland—among land, timber, and other capital accounts as soon as possible. Adjust this basis up for new purchases or investments and down for sales or other disposals. When you sell your timber, you can take a depletion deduction equal to ((Adjusted basis ÷ Total timber volume just before the sale) x (Timber volume sold)). Good records include a written management plan and a map of your forestland. Keep records that support current deductions 6 years beyond the date the return is due. Keep records that support your basis 6 years beyond your period of ownership. Report basis and timber depletion on IRS Form T (Timber), Schedule B.

**Passive Loss Rules**

The passive loss rules are too complex to cover in detail here, but what follows is a very brief summary. Under the passive loss rules, you can be classified in one of three categories: (1) investor, (2) passive participant in a trade or business, or (3) active participant (materially participating) in a trade or business.

The law's intent is that you are "materially participating" if your involvement is regular, continuous, and substantial; however, a low level of activity is adequate if that level is all that is required to sustain the trade or business. This means that record keeping is very important! To show material participation, landowners will need to keep records of all business transactions related to managing their timber stands. Likewise, it would be a good idea to keep records of other business-related activities such as landowner meetings attended, odometer readings to and from meetings, cancelled checks for registration fees, and copies of meeting agendas. Generally, you will get the best tax advantage if you are "materially participating" in a timber business because all management expenses, property taxes, and interest on indebtedness are fully deductible against income from any source. However, if you are "materially participating," you must dispose of your timber under the provisions of Section 631 to qualify for capital gains. (This means that you must sell your timber on a "pay-as-cut" or "cut and convert" basis, rather than lump sum.) If you have considerable passive income (such as annual rental payments), it may be to your advantage to be considered "passive." Most of the discussion that follows applies to forest landowners who are "materially participating."

**Reforestation Tax Credit and Amortization**

The reforestation tax credit and 7-year amortization is one of the best tax advantages for forest landowners. If you reforested during 2002, you can claim a 10-percent investment tax credit for the first $10,000 you spent for reforestation during the tax year. In addition, you can amortize (deduct) all of your 2002 reforestation costs (up to $10,000), minus half the tax credit taken, over the next 7 years (actually 8 tax years). **The election to amortize must be made on a timely tax return for the year in which the reforestation expenses were incurred.** Elect to amortize reforestation expenses on Form 4562. (Passive owners may or may not be eligible for the amortization and credit).

Here's how it works. Assume you spent $4,000 to reforest a cutover tract in 2002. You claim a $400 tax credit (10 percent of $4,000) for 2002. You can also deduct 95 percent of these reforestation costs over the next 8 tax years. Due to a half-year convention you can only claim one-half of the annual amortizable portion for 2002. This means that on your 2002 tax return you can deduct one-half of (0.95 x $4,000 ÷ 7) or $271. For the next 6 tax years you can deduct (0.95 x $4,000 ÷ 7) or $543, and the remaining $271 can be deducted the 8th tax year.

The annual reforestation amortization is claimed on Form 1040 on the line for adjustments rather than being claimed on Schedule A under miscellaneous deductions. (If you use Schedule A for this purpose, you can claim only aggregated miscellaneous deductions that exceed 2 percent of adjusted gross income). Use Form 3468 to claim the investment tax credit.

Any reforestation costs exceeding the $10,000 annual limit should be capitalized (entered into your timber account). You can recover (deduct) these costs when you sell your timber.

A final word of caution: the tax credit and 7-year amortization deductions are subject to recapture if you dispose of your trees—within 5 years of planting for the credit and within 10 years of planting for the amortization.

**Capital Gains and Self-employment Taxes**

If you report your timber sale income as ordinary income, you could pay significantly more in taxes than you would if you report it as a capital gain. Also, capital gains are not subject to the self-employment tax, as is ordinary income. The net self-employment tax rate for 2002 is 15.3 percent for self-employment income of $400 or more. The rate consists of a 12.4 percent component for old age, survivors, and disability insurance (OASDI) and a 2.9-percent component for hospital insurance (Medicare). The maximum income subject to the OASDI component of the tax rate is $84,900, while the Medicare component is unlimited. However, if wages subject to Social Security or Railroad Retirement tax are received during the tax year, the maximum is reduced by the amount

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of wages on which these taxes were paid. To qualify for long-term capital gains treatment, timber sold after December 31, 1997 must have been held longer than 12 months. The maximum long-term capital gains rate for timber sold in 2002 is 20%. (For taxpayers in the lowest income bracket, the maximum rate is 10%).

**Cost-share Payments**

If you received cost-share assistance under one or more of the Federal or State cost-share programs during 2002, you may have to report some or all of it as ordinary income. You have two options. You have the option to include it as income and then recover the part that you pay plus the cost-share payment through the amortization and reforestation tax credit already described. You also have the option to exclude the "excludable portion" from income if certain conditions are met. These conditions are (1) the cost-share program has to be approved for exclusion by the IRS and (2) the maximum amount excludable per acre is the greater of: (a) the present value of $2.50 per acre or (b) the present value of 10 percent of the average income per acre for the past 3 tax years. This second requirement gets rather complicated because you have to determine an appropriate interest rate to compute the present values. Programs approved for exclusion by the IRS include the Forestry Incentives Program (FIP), the Forest Stewardship Incentive Program (SIP), the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), and the Wildlife Habitat Incentive Program (WHIP), plus several State programs (check with your State Forestry Agency for approved programs in your State).

Generally, if you harvested the tract within the last 3 years, probably all of the cost-shares received can be excluded from income. In some cases, taxpayers may be better off to exclude cost-share payments. Other taxpayers may be better off not to exclude cost-share payments. Instead, they may be better off to claim the cost-share payments as part of the reforestation tax credit/7-year amortization. The important point here is: **You must report cost-share payments**. If you decide to exclude, attach a statement to your return that states specifically what cost-share payments you received, that you choose to exclude some or all of them, and how you determined the excludable amount.

**Conservation Reserve Program**

If you planted trees during 2002 under the Conservation Reserve Program (CRP), you must report your annual payment as ordinary income. If you received CRP cost-share assistance funds for planting your trees, you must also report these as ordinary income. CRP cost-share payments used to establish trees can be claimed as part of the reforestation expenses reported for the reforestation tax credit/7-year amortization.

Farmers may treat expenditures for soil and water conservation on farmland as expenses in the year incurred, rather than capitalizing them (CRP expenditures qualify). However, the amount deductible in any year shall not exceed 25 percent of the gross income from farming.

**Casualty Losses**

A casualty loss must result from some event that is (1) identifiable, (2) damaging to property, and (3) sudden and unexpected or unusual in nature. Examples include wildfire and storms. A 1999 Revenue Ruling identified the depletion block–the unit you use to keep track of the adjusted basis of the affected timber–as the appropriate measure of the "single identifiable property damaged or destroyed" in calculating a casuality loss deduction.

The IRS has issued Revenue Rulings on southern pine beetle losses in timber stands, drought losses of planted seedlings, and casualty loss deductions. It ruled that beetle and drought losses generally do not qualify for a casualty loss deduction because they are not sudden. They may, however, qualify for a business- or investment-loss deduction. A 1999 Revenue Ruling identified the depletion block–the unit you use to keep track of the adjusted basis of the affected timber–as the appropriate measure of the "single identifiable property damaged or destroyed" in calculating a casualty loss deduction.

**Management and Maintenance Expenses**

Generally, your annual expenses for the management and maintenance of an existing stand of timber can be expensed or capitalized. In most cases, you are better off to expense those costs during the tax year they are incurred, rather than capitalizing them. If it is not to your advantage to itemize deductions for 2002, you should capitalize these expenses. If you choose to itemize deductions, you can deduct these expenses, but the passive loss rules apply.

**Conclusion**

Congress provided these favorable tax advantages to stimulate increased productivity from the nation's privately owned forestlands. When you take advantage of these favorable provisions you avoid paying unnecessary income taxes, and you earn more income from your woodland operations.

**Reference**

Haney, H. L., Jr.; Hoover, W. L.; Siegel, W. C.; and Greene, John L. 2001. Forest Landowners Guide to the Federal Income Tax. Agric. Handb. 718. Washington, DC: U.S., Department of Agriculture. 157 pp.

(The above handbook is available for sale from the U. S. Government Bookstore at 404-347-1900. The price is $20.00 per copy. Major credit cards are accepted.)

**Tax Information on the Internet**

USDA Forest Service publications are available at: *www.fs.fed.us/spf/coop* and *www.southernregion.fs.fed.us/spf/coop/taxation*

IRS publications and forms are available at: *www.irs.gov*

National Timber Tax Site is located at: *www.timbertax.org*